



President's Message

William Poole

Welcome to the Thirty-First Annual Policy Conference sponsored by the Federal Reserve Bank of St. Louis. There is an interesting combination of advocacy and science in monetary policy research. Here in St. Louis we have advocated a policy of price stability since this conference series began. We have also sought to promote research to understand what the Fed should do as well as how what it does affects the economy. Our support for price stability predates any mathematical model that would help us to understand why it is a good policy. The advocacy of price stability comes from knowledge of history—bad things seem to happen every time and in every place that inflation gets out of hand. It also comes from an old idea that markets work better if prices give clear signals about relative economic values.

The history of monetary macroeconomic research is the interaction of those who try to model what policymakers actually do with those who use such models to explain how the central bank might do even better. The reigning paradigm among monetary policy advisors today is the New Keynesian model, which combines general equilibrium modeling principles with the nominal frictions that are thought to determine the monetary transmission mechanism. Today, the Federal Reserve, the European Central Bank, and other central banks around the world hold conferences that study some aspect of this new consensus. Indeed, our first paper today is an example of a

New Keynesian monetary policy model estimated using U.K. data.

Whether the monetary transmission mechanism in the New Keynesian framework is realistic or not, this framework has become very popular, in my opinion, because it gives sound policy advice—“Stabilize the price level!” During the 1970s, the old Keynesian model fell out of favor, partly because it gave bad policy advice. So it is somewhat ironic that the New Keynesian model is so popular partly because it has developed a theory to support an old monetarist policy position.

Although the New Keynesian model recommends stabilizing the price level, most of the research is done in models where the central bank has a short-run inflation target and also reacts to deviations of output from potential. In theory, the optimal policy within this class of Taylor rules implies substantial volatility in long-term inflation and bond yields. In practice, there is convincing evidence that most of the volatility in the long-term bond market comes from uncertainty about the future inflation rate.

Understanding how monetary policy strategies are related to bond-market outcomes is important for resolving such policy debates as whether the Fed should have an explicit inflation target or whether it should have a systematic response to fluctuations in asset prices. In the next two days, we hope to make some progress in understanding what general equilibrium analysis has brought to the monetary policymaker and in filling in some more of the gaps between theory and practice.

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